Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
GTE CORPORATION,	)	
	)	
Transferor,	)	
	)	
and	)	CC Docket No. 98-184
	)	
BELL ATLANTIC CORPORATION,	)	
	)	
Transferee,	)	
	)	
For Consent to Transfer of Control	)	

SUPPLEMENTAL DECLARATION OF
PROFESSOR RONALD J. GILSON

1. On February 22, 2000, I made a declaration in this proceeding concerning whether the receipt by NewCo, the company arising out of the merger of Bell Atlantic and GTE Corporation, of convertible Class B stock ("Class B stock") representing 10 percent of the voting and dividend rights in DataCo, a publicly held corporation containing the assets of GTE Internetworking ("GTE-I"), would violate section 271(a) of the Communications Act, 47 U.S.C. § 271(a). Section 271(a) generally prohibits NewCo from providing long distance service originating in an in-region state, directly or through an affiliate, without first receiving approval under section 271(b). Thus, if NewCo's Class B stock would render DataCo a NewCo affiliate, section 271(a) would be violated. Under section 3(1) of the Communications Act, 47 U.S.C. § 153(1), DataCo would be a NewCo affiliate if NewCo's Class B stock in DataCo represented "an equity interest (or the equivalent thereof) of *more*

than 10 percent." (emphasis added)

2. Because NewCo's Class B stock represents only a 10 percent voting and income interest in DataCo, it was my opinion that Section 271(a) would be violated on this basis only if the conversion right under the Class B stock constituted an additional "equity interest" under Section 3(1), thereby increasing NewCo's interest in DataCo above Section 3(1)'s 10 percent definitional safe harbor. I concluded that the conversion right associated with Class B stock is not itself an equity interest or its equivalent in DataCo and, therefore, NewCo's contemplated holding of DataCo Class B stock would not violate section 271(a).

3. In an *ex parte* letter to the FCC staff dated March 10, 2000, AT&T takes issue with my conclusion that, for purposes of the statutory structure reflected in Section 271 and Section 3(1), the Class B conversion right is not an equity interest or its equivalent. AT&T supports its position by reference to three cases construing the definition of a "security" under the Securities Exchange Act of 1934: (a) *Magma Power Company v. Dow Chemical Corporation*, 136 F.3d 316 (2nd Cir. 1998); (b) *One-O-One Enterprises, Inc. v. Caruso*, 848 F.2d 1283 (D.C. Cir. 1988); and (c) *Securities and Exchange Commission v. Texas International Corporation*, 498 F. Supp. 1231 (N.D. Ill. 1980). Additionally, AT&T submitted an affidavit of my colleague, John C. Coffee, to support its claim that the application of Communications Act Sections 271 and 3(1) should be resolved under principles governing the federal securities laws. Because reliance on these Securities Exchange Act cases in particular, and on securities law authority generally, to interpret portions of the Communications Act enacted in the aftermath of the breakup of AT&T reflects a fundamental misunderstanding both of the function of the Securities Exchange Act

and of Sections 271 and 3(1) of the Communications Act, I offer this Supplemental Declaration to identify the proper framework of analysis by which the application of Sections 271 and 3(1) should be approached.

4. As discussed in greater detail below, the courts have interpreted the definition of the terms "security" and "equity security" in the federal securities laws by reference to the ends sought to be achieved by the statute. In the cases proffered by AT&T, these ends are: prohibiting short-swing profits (*Magma Power*); preventing fraud in the issuance of securities (*One-O-One Enterprises*); and assuring the dissemination of information in connection with a tender offer (*Texas International*). In each case, the definition of a security or an equity security is the jurisdictional trigger to the Securities Exchange Act's application. And in each case, the Securities Exchange Act's purpose – prohibiting insider trading, assuring disclosure, and preventing fraud – dictates an encompassing definition of the jurisdictional trigger.

5. The ends sought to be achieved by Section 271 and Section 3(1) of the Communications Act, however, are entirely different: to avoid circumvention of Section 271(a)'s requirement of FCC approval of a Bell operating company's provision of in-region long distance service through the use of an affiliate. Thus, the focus of Section 3(1)'s definition of an affiliate is on ownership – the capacity of a party to control, through ownership of an equity interest, another entity that is providing the service for which approval is required. For purposes of the Communications Act, an equity interest is therefore appropriately defined by reference to the right to exercise corporate participation rights -- the right to participate in voting, dividend distributions, and liquidation distributions. This result

is consistent with the principles of modern corporation law.[1] Accordingly, I believe that, for purposes of the Communications Act, an equity interest is appropriately defined by reference to the right to exercise corporate participation rights – the right to participate in voting, dividend distributions, and liquidation distributions.

6. Put differently, an employee stock option, for example, is an equity *security* for purposes of the application of securities law insider trading, disclosure, and anti-fraud rules. Until exercised, however, the option has no corporate participation rights, no capacity to control an entity providing long distance service,[2] and, *for purposes of Section 271*, is therefore not an equity *interest* under the Communications Act until it is exercised. Argument by simile – putting forward the results of a search in the LEXIS securities law

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[1] *See, e.g.*, James D. Cox, Thomas Lee Hazen & F. Hodge O'Neal, II Corporations § 13.1 (1995) ("[B]y virtue of their status as owners of shares, shareholders have three classes of rights against the corporation: (1) rights as to control and management, (2) proprietary rights, and (3) remedial and ancillary rights. The first class of shareholder rights includes . . . voting rights . . . . The second class of shareholder rights, designated as proprietary rights, includes (a) the right to participate ratably in dividend distributions . . . , (b) the right to participate in total or partial liquidation."). *See also infra* n.5; *Paulsen v. Commissioner*, 469 U.S. 131, 138 (1985); *United States v. Evans*, 375 F.2d 730, 731 (9th Cir. 1967); 11 Fletcher's Cyclopedia of the Law of Private Corporations § 5081 (per. rev. ed 1995).

[2] The background rule of law is that options and conversion rights are not regarded as conferring ownership until they are exercised. *See, e.g. Nerken v. Standard Oil Co.*, 810 F.2d 1230, 1232 (D.C. Cir. 1987); ("[O]ne is not an owner of common stock prior to conversion of the preferred or before an option to buy has been exercised."); *Martin v. Schindley*, 442 S.E.2d 239, 241 (Ga. 1994) ("An option to purchase land does not, before acceptance, vest in the holder of the option any interest, legal or equitable, in the land."); *Webb v. R.O.A. General, Inc.*, 773 P.2d 834, 838-39 (Utah Ct. App. 1989) (option holder has no legal title to shares until exchange of shares actually takes place after exercise of option); *Ball v. Overton Square, Inc.*, 731 S.W.2d 536, 540 (Tenn Ct. App. 1987) ("[A]n option to purchase stock does not vest in the prospective purchaser an equitable title to, or any interest or right in, the stock."); *Thatcher v. Weston*, 83 N.E. 360, 361 (Mass. 1908) (holder of option to purchase real estate has no ownership interest in the property).

library for the phrase "equity security" and the words "option" or "conversion" – is not a substitute for analysis of statutory purpose.

7. This Supplemental Declaration proceeds as follows. In Part I, I consider Professor Coffee's brief for the proposition that this proceeding is really a securities law case in disguise. Part II then takes up the securities law cases proffered by AT&T in its letter as support for the proposition that an option is an equity interest. Part III focuses on Professor Coffee and AT&T's insistence that an instrument is equivalent to an equity interest under Sections 271 and 3(1) if the instruments have equivalent value, even if they do not provide equivalent capacity to influence the conduct of the issuer. Finally, I evaluate in Part IV AT&T's response to the parallel I drew in my February 22nd Declaration between the pre-conversion consent requirements associated with the DataCo Class B stock and the more expansive pre-closing consent requirements associated with AT&T's acquisition of MediaOne Group, Inc.[3]

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[3] Before I begin my formal analysis, I must first respond to AT&T's contention that "there is 'no meaningful sense' in which Bell Atlantic could be said to hold a separate 'option,'" and that NewCo's option is a "sham." AT&T *Ex Parte* Letter, at 3 (Mar. 10, 2000). As I explained in my earlier declaration, NewCo's Class B stock will consist of two distinct sets of rights – (i) 10 percent of DataCo's voting and distribution rights; and (ii) a conversion right for a period of five years into shares of stock representing 80 percent of NewCo's voting and distribution rights (reduced by any future issuances of Class A common stock). *See* Gilson Decl. ¶ 8 (Feb. 22, 2000). Whether these rights are contained in one or two instruments is a matter of form and not substance, and is not relevant here. As for AT&T's claim that NewCo's option is a "sham," I previously described why this is not the case: "As with any convertible security, no additional payment is required on conversion, the consideration having been paid when the convertible security was first issued. In this case, NewCo will have paid for the right to convert its Class B shares by the initial transfer of GTE-I's assets to DataCo. If section 271(b) approval or other interLATA relief has not been received within the requisite five-year period, NewCo's option will terminate." *Id.*

I. Professor Coffee's Securities Law Analysis

8. To someone with a hammer, everything looks like a nail. My colleague Professor Coffee, a distinguished securities lawyer, reads Sections 271(a) and 3(1) of the Communications Act and concludes, *sotto voce*, that the statutory structure of the Communication Act's provisions governing FCC approval of Bell operating companies' provision of long distance service originating in an in-region state, directly or through an affiliate, is just like the Securities Act of 1933 and the Securities Exchange Act of 1934. Having found his nail, Professor Coffee then assumes the relevance of the "literally several thousand cases discussing [the terms 'control' and 'affiliate'] in just the LEXIS federal securities library." Coffee Declaration ¶ 8. Indeed, Professor Coffee simply asserts that whether an option constitutes an equity interest under the Communications Act is resolved by the definition of equity security under Section 3(a)(11) of the Securities Exchange Act, which includes any security convertible into an equity security. The only reason offered for why case law under the federal securities laws should control the interpretation of the Communications Act is the claim that "there is strong reason to believe" that Congress modeled the language of the Communications Act of 1934 after the language used in the Securities Act of 1933. Coffee Declaration ¶ 9.

9. Sections 271 and 3(1) of the Federal Communications Act, the statutory provisions of concern in this case, were enacted in 1996, not 1934, in response to the breakup of AT&T, not the stock market crash of 1929, and use *different* language than the federal

securities laws.[4] Thus, Professor Coffee asserts that case law decided under the federal securities laws "is highly relevant to any construction of Section 3(1)" without pausing over either the fact that the Communications Act uses a different term than the securities laws – "equity *interest*," not "equity *security*" – or over the fact that whether an option conveys *current* rather than *future* corporate participation rights matters greatly under the Communications Act, but is irrelevant for the Securities Exchange Act's very different purposes.

10. Section 271 requires Federal Communications Commission (FCC) approval of a Bell operating company's providing in-region long distance service either directly or through an affiliate. Section 3(1)'s definition of an affiliate, adopted at the same time and as part of the same regulatory structure as Section 271, functions to protect the Commission's Section 271 approval right: a Bell operating company cannot avoid the Commission's jurisdiction by providing long distance service through a proxy. Thus, the focus of the inquiry is on ownership – the capacity of a party to control, through ownership of an equity interest, another entity that is providing the service for which approval is required. For purposes of the Communications Act, an equity interest is appropriately defined by reference to the right to exercise corporate participation rights – the right to participate in voting, dividend distributions, and liquidation distributions.[5]

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[4] Sections 271 and 3(1) were added to the Communications Act by the Telecommunication Act of 1996, Pub. L. No. 104-104, 110 Stat. 58, 61, 86 (1996).

[5] It is now commonplace to recognize that three attributes of corporate ownership – the right to participate in voting, dividends, and liquidation – are typically lodged in the corporation's equity interest. The combination of these three corporate participation rights creates the

11. For purposes of Section 271, an option adds nothing to a party's ownership. Because an option conveys no current right to vote, participate in dividends, or participate in liquidation distributions, it conveys no capacity to control the actions of another entity that is rendering in-region long distance services. The *exercise* of the option, in contrast, does convey a current ownership interest and therefore the right to influence the party engaged in the activity for which the statute requires FCC approval. For this reason, the requirement of Commission approval under Section 271 appropriately attaches when conversion of an option translates a *future* equity interest into a *current* equity interest.

12. By comparison, the fact that an option conveys only a future, not a current, ownership interest matters little for purposes of whether the Securities Exchange Act's jurisdiction should be triggered. A purchaser of an option that will convey corporate participation rights when exercised in the future nonetheless requires disclosure in the present when the option is purchased, not just when it is converted. This is because the

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proper incentive structure for the corporation because only those who stand to receive the corporation's income have the right incentives to cause, through their voting rights, the corporation to maximize its profit. *See, e.g.*, Frank H. Easterbrook & Daniel R. Fischel, The Economic Structure of the Corporation 67-68 (1996) ("The reason [only shareholders vote] is that shareholders are the residual claimants to the firm's income [the right to participate in dividends and in the proceeds of liquidation]. Creditors have fixed claims, and employees generally negotiate compensation schedules in advance of performance. The gains and losses from abnormally good or bad performance are the lot of the shareholders, whose claims stand last in line."); John C. Coffee, Jr., Jesse Choper & Ronald J. Gilson, Cases and Materials on Corporations 530 (4th ed. 1995) ("Why is the practice so universal that only common stock should vote? ... Economic theory supplies a plausible explanation for this pattern. Essentially, it asserts that it is more efficient to accord voting rights only to shareholders, as the residual risk-bearers in the firm, and to require other participants to negotiate their rights and entitlements by contract.").

public's need for information about a tradable instrument is not related to whether that instrument represents a present or future equity interest. And if an option is therefore an equity security for purposes of disclosure, then for the same reasons it must also be an equity security for purposes of the anti-fraud rules. This distinction – between the centrality of a current as opposed to a future equity interest in the context of the Communications Act and its irrelevance in the context of the federal securities laws – appears clearly from the elements of the federal securities law that Professor Coffee discusses.

13. Professor Coffee first takes up Rule 16a-4, which states that for purposes of Section 16 of the Securities Exchange Act, derivative securities like options are deemed to be the same class of equity security as that to which the derivative relates – in Professor Coffee's terms, "an option ...[is] 'equivalent' to the underlying security." Coffee Declaration ¶ 17. But given the purpose of Section 16, Rule 16a-4 has no relevance to the interpretation of Sections 271 and 3(1).

14. Section 16(a) requires insiders – large shareholders, officers, and directors – to disclose their holdings of a corporation's "equity securities" and update that disclosure as their holdings change. This disclosure supports Section 16(b)'s restriction on insider trading by these individuals: statutory insiders must turn over to the corporation profits earned on any purchase and sale of the corporation's equity securities made within six months of each other. The statute's purpose is to establish a hard-edged rule to deal with a soft-edged problem. Because inside information is both difficult to define, and because it is even more difficult to establish whether a particular individual actually possessed inside information, Section 16(b) simply restricts the ability of corporate officers and large shareholders, the

group most likely to have inside information, to trade for a specified period of time. Rule 16a-4 reflects the efforts of the Securities and Exchange Commission ("SEC") to adopt regulations addressing the potential for corporate insiders to avoid the application of Section 16 by holding and trading not the "equity security" specified in the statute, but instead a derivative security that would allow the insider to profit in the same way as if an equity security had been traded. The SEC blocked this avoidance technique by extending the statutory definition and prohibition to encompass trading in the derivatives. Rule 16a-4, and Section 16 generally, are not concerned with control, as is the case with Section 271, but only with trading profits. Rule 16a-4's equation of an option to acquire a security and the security itself reflects that purpose: all that matters is whether the derivative security provided the same trading opportunity.

15. Professor Coffee next takes up the discussion, in my February 22nd Declaration, of Rule 144 under the Securities Act of 1933. In my declaration, I noted that even the federal securities laws distinguished between options and equity securities when appropriate to the purpose of the particular provision, and I pointed out that Rule 144 distinguishes between these two categories of instruments for purposes of commencement of the holding period under that rule. Professor Coffee responds that the rule makes even finer distinctions than I referenced in my February 22nd Declaration, treating differently simple options and options that are embedded in a convertible security. Of course, that is precisely the point: the appropriate treatment of an option depends on the purposes of the particular regulatory structure. In some circumstances, the federal securities laws treat options differently from equity securities (and even different types of options differently),

as in Rule 144; and in other circumstances treat options and equity securities the same, as in Rule 16a-4. The appropriate treatment depends on the purpose of the statute.

16. In the end, Professor Coffee repeatedly states that the option reflected in NewCo's Class B conversion right would be equity under the Securities Exchange Act. For example, he states "[i]f the ...question [is] ... whether options constitute equity, the statutory answer is clear. The definition of 'equity security' in Section 3(a)(11) of the Securities Exchange Act of 1934 defines 'equity security' to include: 'any security convertible ... into such a security.'" Coffee Declaration ¶ 15. [6] The only problem is that Professor Coffee and AT&T have the wrong statute in mind. As Professor Coffee notes, *his* area of specialization is the federal securities laws, while *my* specialization is (as he characterizes it) "the more abstract field of corporate finance." The capacity to exercise influence in the manner of concern under Section 271 of the Federal Communications Act is not, however, an issue of federal securities law. I respect Professor Coffee's expertise in his self-defined area of specialization. I question merely its application to this proceeding.

II. AT&T's Case Law Analysis

17. AT&T presents three cases in support of Professor Coffee's proposition that,

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[6] Elsewhere, Professor Coffee stresses that "[i]t has been the consistent approach of the federal securities laws to view derivative securities (and particularly convertible securities) as equivalent to the class into which they are convertible." Coffee Declaration ¶ 16 (emphasis added). The point is made again in ¶1 – "The normal attitude of the federal securities laws toward convertible securities is shown by Rule 16a-4 under the Securities Act of 1934" – and surfaces once more in ¶25: "More importantly, in evaluating issues of ownership and control, the federal securities laws consider not just the formal terms of an instrument, but the facts of the entire transaction." Finally, we are told in ¶ 27 that "[c]ontrol under the federal securities laws has long meant (as SEC Rule 405 under the Securities Act of 1933 expressly states)," followed by an application of Rule 405 to the Class B stock.

because the federal securities laws under certain circumstances treat options as equivalent to "equity securities," Section 3(1) of the Federal Communications Act should treat options as equivalent to "equity interests." Each case deals with a different provision in the federal securities laws, and in each case the court's equation of options and equity securities is consistent with the purposes of the particular federal securities law provision presented. However, in each case the purpose of the federal securities law has nothing whatsoever to do with the purpose of Sections 271 and 3(1) of the Communications Act. Thus, they are irrelevant to the issue presented in this proceeding.

18. *Magma Power* involves the application of Securities Exchange Act Section 16(b) to the complex world of derivative securities, a phenomenon that for practical purposes did not exist at the time the statute was enacted. As discussed in ¶ 14, Section 16(b)'s purpose is to establish a hard-edged rule to deal with the soft-edged problem of insider trading. Rather than defining inside information and imposing the burden on plaintiffs of demonstrating that a defendant actually possessed it, Section 16(b) instead effectively prohibits corporate officers and large shareholders, the group most likely to have inside information, from trading for a specified period of time. *Magma Power* dealt with the SEC's efforts to adopt regulations addressing the potential for corporate insiders to avoid the application of Section 16(b) by trading not the "equity security" specified in the statute, but instead a derivative security that would allow the insider to profit in the same way as if an equity security had been traded. The SEC addressed this problem by extending the statutory prohibition to encompass trading in derivatives. Thus, *Magma Power* deals with a statutory provision that was concerned not with control, as is the case with Section 271, but only with

trading profits. Its equation of an option to acquire a security and the security itself reflects that purpose: all that matters is whether the derivative security provides the same trading opportunity.

19. AT&T's reliance on *One-O-One Enterprises* presents the same confusion over statutory purpose. This case involved a portion of the Securities Exchange Act whose statutory purpose is just as different from that of Section 271 and Section 3(1) of the Communications Act as the portions of the Securities Exchange Act addressed in *Magma Power*. *One-O-One Enterprises* posed the question whether a contractual option to purchase stock was a "security" for purposes of the application of Rule 10b-5's prohibition of fraud in connection with the issuance of a security. Applying the Supreme Court's rule of construction in *Landreth Timber Co. v. Landreth*, 471 U.S. 681 (1985), that an instrument denominated "stock" is a security if it possesses "some of the significant characteristics typically associated with stock," 421 U.S. at 686, the court held that the "right to purchase" an instrument that was stock under the *Landreth* test was itself a security for purposes of the application of the Securities Exchange Act's anti-fraud rules. This is hardly a surprising result. The Securities Exchange Act is directed primarily at assuring proper disclosure concerning publicly offered and traded securities; anti-fraud rules reinforce that disclosure obligation.[7] For purposes of disclosure and rules against fraud, the sale of a security and the

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[7] Professor Coffee has elsewhere described the purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 as follows:

> "Narrow in focus, the '33 Act applies essentially to the initial distribution of securities by the issuer, underwriters, and dealers who sell these securities to the public . . . . Thus, the basic strategy of the '33 Act was to create a system

indirect sale of the security by means of a sale of an option to purchase the security are functionally identical; it is irrelevant if the option does not convey corporate participation rights until it is exercised. In contrast, the option to own a security and the actual ownership of that security are not the same for Sections 271 and 3(1)'s purpose of preventing the circumvention of FCC approval through the use of an affiliate. In the FCC setting, circumvention requires the capacity to influence the affiliates' business decisions. The critical elements are the corporate attributes of ownership: participatory rights in voting, dividends, and distributions. Again, the appropriate definition depends on the statutory purpose; conflating the Securities Exchange Act and the Communications Act simply obfuscates the assessment that the FCC must make in this proceeding.

20. *Texas International*, the last case proffered by AT&T, involves the jurisdictional trigger to the disclosure requirements of the Securities Exchange Act, rather

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> of mandatory affirmative disclosure . . . .
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> The '33 Act also greatly expanded on the common law's definition of actionable fraud . . . .
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> "In contrast to the '33 Act, which established an episodic disclosure system triggered by the offering or dale of securities to the public, the Securities Exchange Act of 1934 (the '34 Act) created a continuous disclosure system.
>
> . . .
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> [W]hile the '33 Act attempts to place the prospective investor on an equal footing with the insider with regard to primary distributions, the '34 Act concentrates on enhancing the market's efficiency by informing the professional investor."

Jesse Choper, John C. Coffee & Ronald J. Gilson, Cases and Materials on Corporations 314-17 (4th ed. 1995).

than its anti-fraud provisions. Under Section 14(d) of the Securities Exchange Act, any person making a tender offer for more than 5 percent of a class of an "equity security ... registered" under the Act must file with the SEC a Schedule 14D containing extensive disclosure concerning the offer contemporaneously with the offer's commencement. The wrinkle in *Texas International* was the object of the offer. Because the target company was in bankruptcy, the offer was made to the holders of creditors' claims that, on the completion of the bankruptcy reorganization, would be exchanged for stock. Thus, the question was whether an offer for a claim that would become an equity security through the operation of the bankruptcy reorganization process was itself an equity security for purposes of triggering Section 14(d)'s disclosure requirement.

21. It is hardly surprising that the court agreed with the SEC that the application of the disclosure requirements should depend on the purpose of the statute, and that the statute therefore applied to what was functionally an offer for an equity security. The bidder's admitted goal was to acquire the stock for which the claims would be exchanged pursuant to the bankruptcy reorganization. Thus, if the statute's goal of requiring disclosure to allow the holder of an equity security to make an informed decision was to be achieved, the term "equity security" had to include the bankruptcy claims; otherwise the statute would never apply. In contrast, the structure of the transaction involved in this proceeding is designed to preserve, not avoid, the FCC's approval rights under Section 271. NewCo's acquisition of a greater-than-10-percent equity interest upon conversion of its Class B stock is independently subject to Section 271 by virtue of the fact that NewCo will have to secure sufficient interLATA relief (*e.g.*, by obtaining section 271 approvals from the FCC) before

it can exercise the conversion rights.

22. In all three cases on which AT&T relies, the fact that the option or option-like interest did not convey current corporate participation rights was irrelevant to the application of the relevant portion of the Securities Exchange Act. In each, the statutory purpose – prohibiting insider trading, requiring disclosure, and preventing fraud – was served by applying the regulation to an instrument that would convey corporate participation rights only in the future – an equity *security* that did not yet convey an equity *interest*. As I discussed in greater detail in my analysis of Professor Coffee's declaration above, little is added to the inquiry that I addressed in my February 22, 2000 declaration by reference to judicial decisions construing a statute whose purposes are so fundamentally different from those of Section 271 and Section 3(1).[8]

III. Professor Coffee and AT&T Confuse Value Equivalence and Control Equivalence

23. With the distraction of the federal securities laws out of the way, I now turn to what AT&T's argument ultimately reduces to. Professor Coffee and AT&T make much of the fact that an option has value, and that an in-the-money option may have the same value

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[8] I should also correct one glaring misstatement of corporate law asserted by AT&T. In footnote 10 of its letter, AT&T states that "Bell Atlantic affiliated directors" would be protected by the business judgment rule when they "cause[d] DataCo to take actions that Bell Atlantic desires." Under standard analysis, such an affiliated director would be treated as interested in the Bell Atlantic desired actions, and would be held to the higher standard of fair dealing with respect to which the director would bear the burden of proof. See American Law Institute, Principles of Corporate Governance: Analysis and Recommendations § 4.01(c) (business judgment rule does not apply to interested directors); § 5.02 (interested directors held to fair dealing standard);§ 1.23 (definition of interest). A significant segment of the plaintiffs' bar devotes itself to policing through litigation instances of director self-dealing. In his declaration, Professor Coffee does not subscribe to AT&T's view.

as the equity interest into which the option will be converted on exercise: "Thus if the Class B stock has a value equivalent to 80% of the value of DataCo, this evidence would strongly support a conclusion that it is equivalent to an 80% interest in DataCo." Coffee Declaration ¶ 18.[9] This argument, like AT&T's reliance on the federal securities law, again loses sight of the purpose of the statutory provisions to be interpreted. Put most simply, what is equivalent depends on why you ask.

24. Section 271 prohibits Bell operating companies from providing in-region long distance service without FCC approval, thereby restricting the achievement of the substantial competitive advantage – through economies of vertical integration and the application of Bell operating company in-region expertise and assets – available from being able to include a long distance component in a combined service offering. For a Bell operating company to achieve these economies through ownership of another entity – an affiliate under Section 3(1) – it must have the capacity to influence the business decisions of the affiliated entity or to benefit from the affiliated company's use of the relationship to achieve these economies. The FCC makes explicit this link between Section 271 and service bundling its decision last week approving the Qwest/U S WEST acquisition. *In re Qwest Communications Int'l Inc. and U S WEST, Inc.*, CC Docket No. 99-272 (rel. Mar. 10, 2000). Listing the factors that must be balanced to determine whether Section 271 would be violated, the FCC identified

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[9] Professor Coffee makes the point again in ¶ 20: "So long as it is recognized that the Class A shares will reflect only around 20% of DataCo's value, it cannot be rationally argued that Bell Atlantic owns less than 10% or the equivalent of DataCo." AT&T also makes the point, stating that "[t]wo things are 'equivalent' when they are equal in value," a proposition which AT&T supports by reference to Black's Law Dictionary.

(a) whether the Bell operating company obtains benefits uniquely associated with the ability to package long distance and local services; (b) whether the bell operating company effectively holds itself out as providing packaged long distance and local services; and (c) whether the Bell operating company performs activities and functions that typically are performed by those responsible for providing packaged long distance and local services. It follows that Section 3(1) is appropriately understood as treating as an equity interest only those investments or other ownership relationships that allow the Bell operating company to accomplish one of the designated factors. Because an option does not convey any corporate participatory rights until it is exercised, it is not an equity interest for purposes of Section 3(1).

25. In contrast to its concern about local and long distance packaging, Section 271 is not concerned with a Bell operating company's passive investments – investments in equity interests of 10 percent or less under Section 3(1) – because such investments do not provide a means for a Bell operating company to achieve the benefits of in-region bundling of services without FCC approval; *i.e.*, without opening its local market to competition. Thus, a Bell operating company could make any number of 10 percent or less investments in different service providers like DataCo, or invest in an Internet mutual fund, without violating Section 271. To be sure, in either of these situations the Bell operating company would benefit from the increase in market value currently associated with Internet companies, but for purposes of Section 271 and Section 3(1) the mere right to share in the increased value of an investment is not the same as having the control necessary to allow the Bell operating company to capture the benefits that Section 271 conditions on FCC approval

– the gains that result from participation or involvement in long distance markets or from bundling local and long distance service. Indeed, through the use of a carefully crafted derivative strategy, a Bell operating company could secure a greater than 10 percent interest in any appreciation in the value of a company in which it invested, even though it had a less than 10 percent equity interest in the company. Such a derivative investment would not increase the Bell operating company's equity interest above 10 percent (and thereby violate Section 271) because the derivative position would not give the Bell operating company the ability to influence the investee's conduct, a necessity for capturing the competitive benefits that Section 271 conditions on FCC approval. Because no additional capacity to influence the investee's conduct accompanies the derivative position, its addition to a 10 percent equity interest would not violate Section 271.

26. Thus, Section 271 and Section 3(1) are not directed at *value* equivalence, but at *control* equivalence – the capacity to exert equivalent influence over the activity that required FCC approval as would an equity interest. Because an option does not convey participation rights, it cannot alone be an equity interest or the equivalent -- regardless of its value. Value equivalence may have great relevance to an interpretation of the Securities Exchange Act's provisions governing insider trading, but this proceeding involves a different statute, concerned not with trading strategies but with the actual operation of the business in which an equity interest is held.

27. A simple, but in these times not unrealistic, example may clarify the error in equating value equivalence and control equivalence. Suppose an employee in a Silicon Valley dot.com company (just down the road from envious Stanford Law School faculty

members) receives employee stock options with an exercise price of $1 a share and with the familiar restriction that the options cannot be exercised for 12 months. A few months later the company goes public at $40 a share. After the IPO, the options have a value of some $39 a share, roughly the equivalent of the value of the equity into which the options are convertible. However, the options convey no participation rights until they are exercised – there is *value* equivalence but not *control* equivalence. The option may be an equity *security* for purposes of various securities law disclosure and insider trading requirements because there is value equivalence, but it is not an equity *interest* for purposes of Section 271 and Section 3(1) unless there is control equivalence. Thus, the option becomes an "equity interest" under the Communications Act only when, through its conversion, the holder gains corporate participation rights that allow it to influence the company's business decisions.

28. With Section 271's purpose in mind, AT&T and Professor Coffee's arguments that the conversion right associated with DataCo's Class B stock independently increases NewCo's "equity interest" in DataCo above Section 3(1)'s safe harbor lose their force. The option structure, by assuring that NewCo can assert no more than 10 percent of the participatory rights associated with DataCo's equity interests without FCC approval or other satisfaction of Section 271, assures that the benefits the statute conditions on satisfaction of Section 271 cannot otherwise be achieved.

IV. Other Indicia of Control

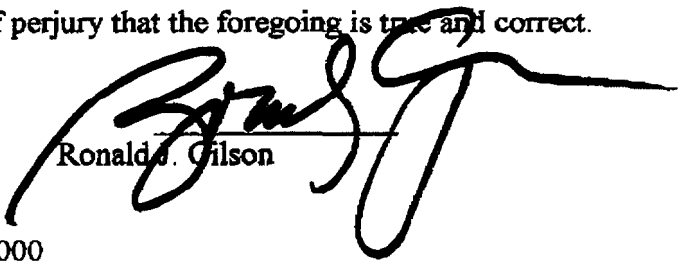
29. In my February 22nd Declaration, I also considered whether certain pre-conversion consent rights to be given to Class B shareholders might themselves give NewCo the ability to "control" DataCo for purposes of Section 3(1) and therefore violate Section 271

independently of the fact that the conversion right itself is not an "equity interest" under Section 3(1). I showed there that these consent rights were functionally and substantively equivalent to the consent rights typically given to an acquiring company with respect to the target company's conduct of its business prior to closing. I further showed that the pre-conversion consent rights associated with Class B stock were, if anything, less extensive than those given AT&T in the agreement governing its acquisition of MediaOne Group, Inc.

30. In its *ex parte* letter, AT&T responded to my analysis in a surprising fashion: it simply misstates its own agreement. AT&T characterizes their rights with respect to MediaOne's pre-closing conduct as merely "negative covenants that are simply designed to preserve MediaOne intact pending AT&T's acquisition. If MediaOne takes an action that violates one of its covenants, AT&T can walk away from its deal." In contrast, NewCo "will have the legal right to force compliance by DataCo," a "power that AT&T lacks with respect to MediaOne." AT&T Ex Parte at 12. In fact, AT&T's acquisition lawyers protected their client better than their client now acknowledges. Its pre-closing consent rights are no different from NewCo's pre-conversion consent rights. As AT&T contends, Section 10.1 of the AT&T/MediaOne agreement does give AT&T the right to "walk away" from its deal if MediaOne violates a covenant. However, that is not all AT&T can do in response to a MediaOne breach. Section 10.2, the very next subsection in the AT&T/MediaOne agreement, gives AT&T the right to sue MediaOne for damages if it breaches its covenants, even if AT&T does walk away. While a damages claim does not explicitly give AT&T the right to compel MediaOne's actions, the size of the potential damages claim would provide the functional equivalent. The $7 billion damages award in the litigation arising out of the

Pennzoil acquisition likely substantially understates the potential damages from a breached acquisition agreement in the current consolidating market for cable companies. Moreover, there is nothing in the AT&T-MediaOne agreement that restricts AT&T's ability to seek specific performance "to force compliance" by MediaOne, a claim that is perfectly plausible given the importance AT&T has placed on the MediaOne acquisition. If DataCo breaches its pre-conversion consent obligations, NewCo would have a lawsuit for damages or specific performance, precisely the same causes of action available to AT&T in the event of a similar breach by MediaOne.

I declare under penalty of perjury that the foregoing is true and correct.



Ronald J. Gilson

Executed on March 14, 2000

B

Before the
FEDERAL COMMUNICATIONS COMMISSION
Washington, D.C. 20554

In the Matter of	)	
	)	
GTE CORPORATION,	)	
	)	
Transferor,	)	
	)	
and	)	CC Docket No. 98-184
	)	
BELL ATLANTIC CORPORATION,	)	
	)	
Transferee,	)	
	)	
For Consent to Transfer of Control	)	

DECLARATION OF IRA H. PARKER

I, Ira H. Parker, depose and state:

1. I am a Vice President and Deputy General Counsel of GTE Corporation ("GTE"). In addition, I am the Vice President and General Counsel of GTE Internetworking Incorporated ("GTEI"), a wholly-owned subsidiary of GTE. I have been the Vice President and General Counsel of GTEI since November 1997. The statements in this declaration are based on my personal knowledge.

2. GTEI contains two first tier subsidiaries, BBN Corporation ("BBN") and GTE Intelligent Network Services Incorporated ("GTE INS"). As Vice President and General Counsel of GTEI, I am responsible for the provision of legal services to GTEI and all of its subsidiaries. BBN Corporation was acquired by GTE in 1997 and consists of two principal divisions: a U.S. Government research and development organization; and a commercial Internet arm. At the time

of its acquisition by GTE, BBN referred to the two divisions as BBN Technologies and BBN Planet, respectively. GTE combined BBN Planet with its pre-existing commercial Internet assets, including GTE INS, and operates that business today as GTE Internetworking.

3. While BBN Technologies legally exists as a part of a GTEI subsidiary, operationally it reports into a unit of GTE other than GTEI, namely the GTE Technology Organization ("GTO"). The GTO represents GTE's centralized research and development arm and also includes GTE Laboratories. This functional separation of BBN Technologies, which took place in early 1999, evidences the divergence of the businesses of BBN Technologies and GTEI.

4. GTEI is a Tier 1 Internet backbone provider, and also offers a suite of value-added Internet services such as web hosting, virtual private networks and managed security services to commercial customers.

5. BBN Technologies is primarily a U.S. Government research and development organization. BBN Technologies' principal divisions include Speech and Language Processing, Mobile Networking, Distributed Applications, Information Security, Emerging Business Operations, Maritime Systems, Applied Physics, Professional Services, Internetworking Research, Federal Network Systems and High Performance Computing. In 1999, BBN Technologies had revenues of approximately $186 million. Approximately 80% of its 1999 revenues were generated from the performance of federal government contracts and subcontracts.

6. BBN Technologies performs little Internet related research and development. In fact, GTEI paid BBN Technologies less than $600,000 for its services in 1999. This GTEI work constituted approximately 0.3% of BBN Technologies' 1999 revenues. The amount GTEI paid

to BBN Technologies represented less than 0.05% of GTEI's 1999 actual operating expenses. As these figures demonstrate, GTEI simply does not rely on BBN Technologies' services in any meaningful way.

7. However, BBN Technologies does perform research and development in a number of areas that are strategic to GTE. For example, BBN Technologies' Speech and Language Processing group has, for a number of years, been working with GTE's incumbent local exchange carrier in an effort to automate the telephone operation's call centers using BBN Technologies' proprietary speech recognition technology.

8. A number of factors led GTE and GTEI management to conclude that BBN Technologies should remain with GTE. The fact that BBN Technologies is an integral part of the GTO was an important consideration. Perhaps even more compelling, however, is the fact that the nature of BBN Technologies' business is more consistent with the mission of GTE, and ultimately the combined GTE/Bell Atlantic, than it is with the mission of GTEI.

9. To the extent that GTEI finds it necessary in the future to turn to third parties to meet its research and development needs, BBN Technologies may be one of any number of vendors with which it works. GTEI will contract for any such effort on a task by task basis, on the same terms it would require from other providers. GTEI will not use BBN Technologies in a significant manner and it has not made, nor will it make, any type of volume or exclusivity commitment to BBN Technologies.

I declare under penalty of perjury that the foregoing is true and correct.

Ira H. Parker

3/14/00
Date